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SUBJECT: REVIEW OF MEXICAN STATE DEPENDENCE ON
FEDERALLY-COLLECTED FUNDS (THIRD OF THREE-PART SERIES ON
MEXICAN FEDERAL-STATE RELATIONS)

REF: A. A. MEXICO 3961
¶B. B. MEXICO 3962
¶C. C. MEXICO 4019

Summary

¶1. (SBU) States and municipalities depend for the vast majority of their revenue on federally collected value-added tax and petroleum revenue funds, but the Fiscal Coordination Law prohibits the GOM from conditioning transfers. On average, 90 percent of state revenue and nearly 75 percent of municipal revenue (which is channeled through the state) come from federal transfers, although the exact amount varies considerably by state and municipality. "Participaciones" and "aportaciones" are the mechanisms for federal transfers. Participaciones are unconditional and comprise each underlying entity's share of oil and VAT revenues according to a national formula that factors in population and poverty level. Aportaciones are earmarked funds that cover the costs of public services such as education and health care. Specific federal budget lines are determined by an opaque annual budget process that originates with Hacienda (Mexico's national treasury), and works its way through Congress before funds are distributed to the states. End summary.

Feds Lack Fiscal Leverage Over the States

¶2. (SBU) The Fiscal Coordination Law prevents the federal government from conditioning transfers based on state support for federal initiatives. Consequently, our contacts told us that states do not have to bow to the national government because of funding needs. The president has little discretionary maneuver through this part of the budget process, and no margin once Congress allocates the funds. However, he may have an opportunity to influence governors through the federal budget process during which the GOM prioritizes national programs and releases technical studies that impact the implementation of regional infrastructure projects. As a senior official at Hacienda told us, if the next president were to reverse President Fox's decision that made the public safety ministry an independent entity (and return it to sub-ministry status), then he would have an additional pool of millions of pesos to leverage with the states.

¶3. (SBU) States have their own revenue-generating capabilities. They have become more adept at accessing the domestic capital market as a consequence of macroeconomic policies (designed to rebuild the banking system and restore sovereign credit) following the 1994-95 peso crisis. The constitution also gives them the right to levy state-wide taxes, although their tax systems are generally weak. Increases in oil revenues have reduced their incentive to improve tax collection; however some states, such as Michoacan, have implemented new taxes in order to diversify their revenues and make themselves more attractive to potential investors.

¶4. (SBU) Although states have no independent means to influence national macroeconomic initiatives, they engage in regular dialogue with Hacienda and have lobbied for and against policy changes that affect the state share of federally-collected revenues. States are able to finance infrastructure by accessing bank loans or by issuing "certificados bursatiles" in the capital market. Mexico's sub-national bond market emerged in 2001 and has yielded $13 billion in financing to states and municipalities. By contrast, NAD bank has financed just under $105 million in loans to Mexico since 1994 and there remains an enormous backlog in requests for project financing. Under Mexican law, states may only borrow in the national currency; any dollar-denominated loans from multilateral development banks must be funneled through the federal government.

¶5. (SBU) As reported ref B, a Bank of Mexico concern is the ability of states to make long-term employment and other commitments based on petroleum-related revenues that may go up and down based on oil prices and the national formula

described above. A senior Bank of Mexico official saw the issue of long-term state spending commitments not being tied to guaranteed revenue flows as a major federal/state issue and financial challenge for Mexico.

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